NO. 93-249

In the Supreme Court of the United States

OCTOBER TERM 1992

Supreme Court, U.S.
FILED
AUG 6 1993
OFFICE OF THE CLERK

JAMIEL AND ELIZABETH CHAGRA,
Petitioners

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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24 pp

QUESTIONS PRESENTED

I

Petitioners claimed attorney fees in the United States Tax Court under Section 7430 of the Internal Revenue Code which was denied. The Tax Court subsequently entered its decision which was timely appealed. The Second Circuit sua sponte held the denial of attorney fees was not timely appealed. The question presented is whether the denial of attorney fees was separately appealable.

II

In determining petitioners' income for 1980 and 1981 the expenditure method was used. However, no likely source to generate income was established. The Second Circuit sua sponte held a likely source could be inferred.

III

In determining petitioners' income for 1978 that was barred by limitations absent fraud the Second Circuit held that petitioners, not the government, had the burden of proving the nature of a stipulated expenditure which accounted for unreported income.

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SUPREME COURT OF THE UNITED STATES
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JAMIEL AND ELIZABETH CHAGRA,
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versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners Jamiel and Elizabeth Chagra respectfully pray a Writ of Certiorari issue to review the Judgment of the Second Circuit Court of Appeals entered in this proceeding on February 2, 1993 and the denial of a Petition for Rehearing on June 9, 1993.

CITATIONS TO OPINIONS BELOW

The United States Tax Court entered its opinion reported in Tax Court Memo 1991-366. The Second Circuit Court of Appeals entered its opinion which has not been published to date.

JURISDICTION

Petitioners appeal from the judgment of the Second Circuit decided February 2, 1993. Petitioners' petition for rehearing was denied on June 9, 1993. Jurisdiction of this Court is invoked under 28 U.S.C. 1254 and 2101 and Supreme Court Rule 10.

STATEMENT OF THE CASE

Attorney Fees

The issues in this case involved the income tax liabilities of petitioners for 1977 through 1981 and the civil fraud penalty for 1977, 1978, and 1980. The tax liability for all years was claimed to be $6,344,474. In the Tax Court's decision the tax liability was reduced to $1,708,299, a reduction of 73%. Included in the reduction was a two million dollar adjustment to unreported income in 1979 which the Tax Court found to be arbitrary and capricious.

Petitioners filed a Motion for Award of Reasonable Litigation Costs which was denied on March 30, 1992. The U.S. Tax Court entered its decision on the merits disposing of the case on July 8, 1992 from which a timely notice of appeal was filed with the Second Circuit. The Second Circuit sua sponte erroneously held the denial of attorney fees was not timely appealed.

Inferring Facts

Income tax liabilities were determined against the appellants for 1980 and 1981 with the Commissioner of In-

ternal Revenue utilizing the expenditure method. It was stipulated that Elizabeth Chagra was not engaged in an income producing activity in either year. It was further stipulated that Jamiel Chagra was a fugitive from justice in the first few months of 1980 and was incarcerated thereafter. The Tax Court made no finding of fact reflecting a likely source of income to account for the expenditures. The Second Circuit held that the source could be inferred.

Burden of Proof

On their 1978 return appellants reported net gambling profits of $1,311,192. In 1978 appellants paid a $915,000 gambling debt in cash to Caesar's Palace. The unreported income determined by the Tax Court for 1978 was $291,866 which amount included the $915,000 payment. In its panel opinion the Second Circuit held that "Petitioners have the burden of proving they are entitled to deductions" rather than the government having to prove the inclusion of the $915,000 expenditure as additional income was proper.

REASONS WHY THE WRIT SHOULD BE GRANTED

I

The Second Circuit's sua sponte statutory construction theory that the denial by the Tax Court of requested attorney fees under Section 7430 of the Internal Revenue Code was an appealable order is in direct conflict with the statute and the decision of the Third Circuit.

The Second Circuit overlooked subsection (e) of Section 7430 as applicable to proceedings commenced prior to 1988:

> "(e) Right of appeal.
>
> An order granting or denying an award for reasonable litigation costs under subsection (a), in whole or in part, shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner as the decision or judgment."

Subsection (e) of Section 7430 was amended in Public Law 100-647 for actions commenced after November 10, 1988 to provide:

> "(f) Right of appeal.
>
> (1) Court proceedings, - An order granting or denying (in whole or in part) an award for reasonable litigation or administrative costs under subsection (1) in a court proceeding, may be incorporated as a part of the decision or judgment in the court proceeding and shall be subject to appeal in the same manner as the decision or judgment."

The issue of attorney fees is expressly not severable from the decision of the Tax Court on the merits of the case. The issue may not be appealed separately, *Randazzo v. U.S.*, (3d Cir. 1984) 751 F.2d 145, 55 AFTR2d 85-531, only as a part of the decision on the merits. The Second Circuit erred in concluding it had no jurisdiction to review the elements required of Section 7430 as to the exhaustion of

administrative remedies, prevailing party, and the reasonableness of the government's position. *Zinniel v. Commissioner,* (7th Cir. 1989) 883 F.2d 1350, 64 AFTR2d 89-5729.

Not only does the Second Circuit decision create a conflict but a continuing one for future cases in the Tax Court. Is a prevailing taxpayer to appeal an order relative to attorney fees or wait for a decision by the Tax Court made months after a computation is made of the tax liabilities pursuant to Rule 155 of the Tax Court's Rules of Practice? In *Portillo v. Commissioner,* (5th Cir. 1993) ____ F.2d ____, 71 AFTR2d 93-1395 the Fifth Circuit reversed a Tax Court decision on the merits, on remand reimbursement for attorney was denied, on appeal the Tax Court was again reversed with the Fifth Circuit holding the elements of Section 7430 had been fulfilled on the merits. In *Portillo* the merits of the case had to be reviewed in order to determine recovery of attorney fees; the two issues are inextricably intertwined as is their appeal.

The issue is of national importance due to its recurring nature whenever a taxpayer prevails in litigation before the Tax Court.

II

The legal standards applicable in an expenditure case have been expressed by the Second Circuit in *U.S. v. Citron,* (2d Cir. 1986) 783 F.2d 307, 57 AFTR2d 86-779 and in *Llorente v. Commissioner,* (2d Cir. 1981) 649 F.2d 152, 48 AFTR2d 81-5028. Under *Citron* expenditures are compared with beginning assets and under *Llorente* the Second

Circuit required evidence linking the taxpayer with an income producing activity. In its panel opinion the Second Circuit sua sponte held that:

> "Petitioners stipulated that their cash expenditures exceeded their reported income in 1980 and 1981. Since there is no evidence that they had a cash hoard, this stipulation supports the inference that they had some amount of unreported income. Furthermore, there is abundant evidence in the record that Jamiel Chagra was engaged in substantial drug trafficking. It is rational to conclude that he continued to receive income from drug trafficking in 1980 and 1981, despite the fact that he was a fugitive in the first two months of 1980 and was incarcerated thereafter. As the Tax Court noted, Petitioners spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income. Since there is a rational basis for the inference that Petitioners had a source of income, Petitioners have the burden of proving that the amount the Respondent claims was income came from a non-taxable source. *See Llorente,* 649 F.2d at 156."

In the entire record there is not one iota of evidence indicating that Jamiel Chagra was engaged in drug trafficking in 1980 nor in 1981. The Tax Court in its opinion made no such finding of fact. On appeal, the government made no such assesrtion.

The Supreme Court has expressly rejected the authority of an appellate court to independently make its own determination of fact. *Helvering v. Rankin*, 295 U.S. 123 (1935) ("The Court of Appeals is without power, on review of proceedings of the Board of Tax Appeals, to make any findings of fact."); *Helvering v. National Grocery Company*, 304 U.S. 282 (1938). The reasoning of the panel of the Second Circuit violates the principals of both *Citron* and *Llorente* as well as the clearly established principals expressed by the Supreme Court.

On the issue as to where the expenditures made in 1980 and 1981 were derived, it is noteworthy that the appellants' reported net gambling winnings in excess of $1,300,000 in 1979, as the Tax Court so found. In addition, the Commissioner of Internal Revenue asserted that appellants had realized another $2,000,000 of gambling winnings in 1979. The Tax Court so found as facts although rejecting the additional $2,000,000 as being arbitrary and capricious without adequate investigation.

The Commissioner of Internal Revenue's practice of reconstructing income utilizing indirect methods such as the case expenditure method is widespread. To permit the appellate court to substitute its own finding of fact will breed litigation and appeals. If the panel decision is upheld, it is in direct conflict with opinions of other circuits including *Olin Corporation v. Commissioner*, 128 F.2d 186 (7th Cir. 1942) ("We have nothing to do with weighing the evidence, drawing inferences therefrom, or making findings of fact."); *Regensburg & Sons v. Helvering*, 130 F.2d 510 (2d Cir. 1942) ("We are powerless to make findings upon those issues or indeed any other findings."); *Koch v. Com-*

missioner, 146 F.2d 262 (9th Cir. 1944) ("...it is the function of the Tax Court, not this court, to draw inferences from facts and to choose between conflicting inferences."); *Lewis v. Commissioner,* 160 F.2d 844 (1st Cir. 1947) ("Where an essential finding is lacking and such finding is necessary to a proper decision of the case, the correct procedure is to remand the case to the Tax Court to make such a finding."); *Helvering v. Ward,* 78 F.2d (8th Cir. 1935) ("The Court of Appeals is without power, on review of proceedings of the Board of Tax Appeals, to make any findings of fact."); *Brutsche v. Commissioner,* 585 F.2d 436 (10th Cir. 1978).

The invalidly of the Second Circuit's inferential approach is also clearly reflected on the fraud issue. For the year 1980 the civil fraud penalty was proposed by the Commissioner, approved by the Tax Court and affirmed by the Second Circuit panel which held that there was a rational basis for the "inference" that petitioners had a source of income and that the burden of proving the expenditure was not income was that of appellant. However, it is well established tax law that the burden of proving fraud rests on the government and to do so by clear and convincing evidence. "Inferences" will not suffice. *Holland v. U.S.,* (Sup. Ct. 1954) 348 U.S. 121, 46 AFTR 943); *Toussaint v. Commissioner,* (5th Cir. 1984) 743 F.2d 309, 54 AFTR2d 84-6092.

III

The Second Circuit erred in holding that the burden of proving unreported income was on appellants.

The income tax liability of appellants for 1978 was barred by the statute of limitations unless the Commissioner proved the 1978 return was fraudulent. Fraud has two elements which the Commissioner must establish by clear and convincing evidence: (1) a deficiency in tax liability (2) which was due to fraud.

Subsequent to trial the Tax Court entered its opinion and subsequently its decision that appellants had understated their 1978 income by only $291,866 which figure included as income the payment of a $915,000 gambling debt to Caesar's Palace.

In its opinion the panel of the Second Circuit held that "Petitioners have the burden of proving they are entitled to deductions."

The deductibility of the $915,000 is not at issue, to the contrary the issue is whether the Commissioner has carried its burden of proving the expenditure constituted additional unreported income. Correctly stated the appellants have no burden to produce any evidence whatsoever. The appellants failure to persuade the Tax Court of anything is judicially irrelevant in determining whether the Commissioner has carried its burden of proving fraud. *Drieborg v. Commissioner* (6th Cir. 1955) 225 F.2d 216, 218, 47 AFTR 1830. Absent that evidence no deficiency in tax existed for 1978, therefore no fraud, and the statute of limitations barred the assessment of additional income taxes.

Correctly placing the burden of proof is fundamental to every fraud case litigated in the U.S. Tax Court. Per-

mitting the instant holding to stand will simply breed future tax trials and appeals.

In view of the conflict of the decision below with the past decisions of this Court and those of other Circuit Courts, the Supreme Court may wish to consider summary reversal.

CONCLUSIONS AND PRAYER

Because of the importance and broad application of these issues in Federal tax cases, the petitioners pray that this Court grant a Petition of Certiorari to the United States Supreme Court.

Respectfully submitted,

TOWNER SHIELDS LEEPER

JOHN LEEPER

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the second day of February, one thousand, nine hundred and ninety three.

Present:

Honorable William H. Timbers,
Honorable John M. Walker, Jr.,
Honorable Joseph M. McLaughlin,

Circuit Judges.

FILED
FEB 2 1993

JAMIEL CHAGRA AND ELIZABETH CHAGRA,

ORDER
No. 92-4152

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court.

This cause came on to be heard on the transcript of record from the United States Tax court,and was submitted for decision.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said Tax Court be and it hereby is affirmed.

Petitioners-Appellants Jamiel Chagra and Elizabeth Chagra, appeal the decision of the United States Tax Court entered July 8, 1992 (L.W. Hamblen, Jr., *Judge*) determining their income tax deficiencies for the years 1977 through 1981. Petitioners filed a petition with the Tax Court for redetermination of those years after Respondent served them with a Notice of Deficiency. On August 6, 1991, the Tax Court (Howard A. Dawson, *Judge*) issued an opinion, reserving entry of decision under Tax Court Rule 155. On March 30, 1992, Judge Dawson denied Petitioners' Motion for Award of Reasonable Litigation Costs under 26 U.S.C. § 7430 (1992).

Petitioners' first argument is that the Tax Court erred in refusing to credit Petitioners for any cash on hand for the years 1977, 1978, 1980 and 1981, in which years Respondent used the cash expenditure method of reconstructing income. When using the cash expenditure method, which determines income based on cash outlays not attributable either to cash on hand at the beginning of the year or to assets liquidated during the year, a court must determine the cash on hand at the beginning of each year. *United States v. Citron*, 783 F.2d 307, 316 (2d Cir.

1986). Petitioners claim that they had a cash hoard at the beginning of 1977. However, the Tax Court determined that there was no cash on hand at the beginning of each of the years in question, relying on several factors. First, Petitioners responded in an interrogatory that they were broke in 1977. Second, in 1977, Respondent seized Petitioners' home in El Paso for non-payment of taxes, which the Tax Court found is not consistent with Petitioners' contention that they had a vast cash hoard. Finally, a revenue agent testified that there was no identifiable cash on hand at the beginning of any tax period. In light of the evidence considered by the Tax Court, we find that its determination not to credit Petitioners with any cash on hand was not clearly erroneous.

Petitioners also argue that the Tax Court erred in disallowing a $915,000 deduction from income in 1978 for a payment to Caesar's Palace for a gambling debt. Under 26 U.S.C. § 165(d) (1992), gambling losses may be used to offset gambling gains, but may not be used to offset other income. Petitoners have the burden of proving they are entitled to deductions. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) Here, the only evidence of any gambling income in 1978 is the fact that Petitoners, who at the time were receiving large amounts of cash from Jamiel Chagra's drug-trafficking activities, declared $1,521,830 in income from gambling in 1978 on their tax return. The district court's disallowance of this deduction was not clearly erroneous.

Petitioners' third claim is that the Commissioner failed to establish a source of income for the years 1980 and 1981, which it contends is required by *Llorente v. Commis-*

sioner, 649 F.2d 152, 156 (2d Cir. 1981). *Llorente* merely holds that while a Notice of Deficiency is presumed to be correct, it must be supported by "rational underpinnings." *Id.* Here, there clearly is a rational basis for the determination that Petitioners had income in 1980 and 1981. Petitioners stipulated that their cash expenditures exceeded their reported income in 1980-1981. Since there is no evidence that they had a cash hoard, this stipulation supports the inference that they had some amount of unreported income. Furthermore, there is abundant evidence in the record that Jamiel Chagra was engaged in substantial drug trafficking. It is rational to conclude that he continued to receive income from drug trafficking in 1980 and 1981, despite the fact that he was a fugitive in the first two months of 1980 and was incarcerated thereafter. As the Tax Court noted, Petitioners spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income. Since there is a rational basis for the inference that Petitioners have the burden of proving that the amount the Respondent claims was income came from a non-taxable source. *See Llorente,* 649 F.2d at 156.

Petitioners' final contention is that the Tax Court erred in refusing to award them litigation costs under 26 U.S.C. § 7430, since the Tax Court lowered the deficiency for 1979 by approximately two million dollars. This issue is not properly before this court. The Motion for Award of Reasonable Litigation Costs was denied on March 30, 1992. The appeal before this court is an appeal from the Tax Court's decision of July 8, 1992, the only decision referenced in the Notice of Appeal. The July 8, 1992 decision does not mention the March 30, 1992 order or litigation

costs. Therefore, defendant has not appealed from the March 30, 1992 order, and we dismiss Petitioners' claim for attorneys' fees.

For the reasons set forth above, the judgment of the Tax Court is affirmed, and Petitoners' appeal of the March 30, 1992 order denying litigation costs is dismissed.

/s/ Wm. H. Timbers

Hon. William H. Timbers, U.S.C.J.

/s/ J. M. Walker

Hon. John M. Walker, Jr., U.S.C.J.

/s/ Joseph M. McLaughlin

Honorable Joseph M. McLaughlin, U.S.C.J.

N.B. THIS SUMMARY ORDER WILL NOT BE PUBLISHED IN THE FEDERAL REPORTER AND SHOULD NOT BE CITED OR OTHERWISE RELIED UPON IN UNRELATED CASES BEFORE THIS OR ANY OTHER COURT.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the second day of February, one thousand, nine hundred and ninety three.

Present:

Honorable William H. Timbers,
Honorable John M. Walker, Jr.,
Honorable Joseph M. McLaughlin,

Circuit Judges.

FILED
FEB 2 1993

JAMIEL CHAGRA AND ELIZABETH CHAGRA,

ORDER
No. 92-4152

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Appeal from the United States Tax Court.

This cause came on to be heard on the transcript of record from the United States Tax Court, and was submitted for decision.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said Tax Court be and it hereby is affirmed.

— ISSUED AS MANDATE 6/18/93 —

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

FILED
JUN 9 1993

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the ninth day of June one thousand, nine hundred and ninety three.

JAMIEL CHAGRA AND ELIZABETH CHAGRA,
Petitioners

DOCKET NUMBER:
92-4152

- V. -

COMMISSIONER OF INTERNAL REVENUE,
Respondent

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by

Upon consideration by the panel that decided the appeal, it is

Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judge of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

FOR THE COURT
ELAINE B. GOLDSMITH, Clerk
By:

/s/ Carolyn Clark Campbell

Carolyn Clark Campbell
Chief Deputy Clerk

(2.)

Supreme Court, U.S.
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v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether, in reconstructing the income of taxpayers who have stipulated to cash expenditures in excess of their reported income for the years in question, the Commissioner of Internal Revenue is required to establish the source of their unreported income.

2. Whether petitioners bore the burden of proving that they were entitled to income tax deductions for gambling losses under Section 165(d) of the Internal Revenue Code, 26 U.S.C. 165(d).

3. Whether the court of appeals properly declined review of the March 30, 1992, Tax Court order denying litigation costs when petitioners' notice of appeal specified that they were appealing the July 8, 1992, Tax Court order on the merits of the tax claims involved.

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In the Supreme Court of the United States

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JAMIEL CHAGRA AND ELIZABETH CHAGRA, PETITIONERS

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A5) is unpublished, but the judgment is noted at 990 F.2d 1250 (Table). The opinion of the Tax Court is unofficially reported at 60 T.C.M. (RIA) ¶ 91,366 (1991).

JURISDICTION

The judgment of the court of appeals was entered on February 2, 1993. The petition for rehearing was denied on June 9, 1993 (Pet. App. A8-A9). The petition for a writ of certiorari was filed on August 6, 1993. The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

STATEMENT

1. Petitioner Jamiel Chagra was convicted on drug smuggling and importation charges in 1979 (C.A. App. 5). During the period from 1977 to 1981, petitioner and his wife, Elizabeth Chagra, made cash expenditures in excess of $3,000,000 for petitioner's drug-trafficking activities, the extensive remodeling of their Las Vegas house, the purchase of jewelry, furniture and automobiles, and a $75,000 fee paid for the attempted assassination of an Assistant United States Attorney (*id.* at 6-25). Petitioners failed to maintain books and records reflecting their income for those years (*ibid.*).

On audit of their federal income tax returns for those years,[1] the Commissioner reconstructed petitioners' income for 1977, 1978, 1980, and 1981 on the basis of the source and application of funds method.[2] For the taxable year 1979, petitioners' income was reconstructed using the specific item method.[3] Deficiencies in income tax ($2,638,011) and additions to

[1] Petitioners filed joint federal income tax returns for the years 1978, 1979, 1980, and 1981. Petitioner Jamiel Chagra filed a separate return for 1977.

[2] Under this method, the amount by which the taxpayer's cash expenditures during a taxable period exceed his known sources of income for the period is deemed taxable income unless the taxpayer can show that his expenditures were made from a nontaxable source of funds. *See DeVenney* v. *Commissioner*, 85 T.C. 927, 930-931 (1985).

[3] Under this method, the government produces evidence that the taxpayer received specific items of reportable income that did not appear on the taxpayer's income tax return. *See United States* v. *Horton*, 526 F.2d 884, 886 (5th Cir.), cert. denied, 429 U.S. 820 (1976).

tax for fraud ($1,349,006) were asserted against petitioner Jamiel Chagra for the year 1977 and against petitioners jointly for the years 1978 through 1981 (C.A. App. 3).

Petitioners sought redetermination of these deficiencies in the United States Tax Court. In responsive pleadings, the Commissioner asserted additional deficiencies for the years 1977, 1978, and 1980 in the aggregate amounts of $1,571,638 in income tax and $785,819 in additional fraud penalties (C.A. App. 3).

Pursuant to its order entered on August 6, 1991, the Tax Court determined that petitioners had unreported income in the aggregate amount of $1,297,015 and were liable for deficiencies in tax and additions to tax for fraud for these years in the aggregate amounts of $1,142,821 and $565,478, respectively (C.A. App. 125).

On January 6, 1992, petitioners filed a motion for award of litigation costs under Section 7430 of the Internal Revenue Code. Petitioners asserted that they had substantially prevailed with respect to the amounts in issue for the 1979 tax year (for which the Tax Court had reduced the asserted deficiency from $1,267,118 in tax and $663,559 in addition to tax to $2,883 in tax and no addition to tax) and that the Commissioner's deficiency determination for that year—based on the specific item method of reconstructing income—was arbitrary and not substantially justified.

On March 30, 1992, the Tax Court entered its order denying petitioners' motion for litigation costs. The court held that petitioners "did not prevail with respect to the main issues in this proceeding" and

that the position of the Commissioner was reasonable (C.A. App. 106). The Tax Court stated that (*ibid.*):

> [t]o the extent we ruled for petitioners in this proceeding, those rulings resulted from the resolution of factual issues, the supporting facts of which may not have been fully developed prior to trial. Given the overall factual complexity of this case, we conclude that [the Commissioner's] position herein was reasonable under these circumstances.

The Tax Court entered its final decision on the merits of the deficiencies on July 8, 1992, "[p]ursuant to the opinion of the Court filed August 6, 1991" (C.A. App. 125). In that order on the merits of the case, the court made no reference to its order of March 30, 1992, concerning litigation costs. On September 1, 1992, petitioners filed a notice of appeal from the Tax Court's decision entered July 8, 1992 (*id.* at 127).

2. The court of appeals affirmed (Pet. App. A1-A5). The court held that the Tax Court properly disallowed a deduction for payment of a $915,000 gambling debt in 1978 because gambling losses may only be deducted against gambling income under Section 165(d) of the Code, 26 U.S.C. 165(d). The court noted that "the only evidence of any gambling income in 1978 is the fact that Petitioners, who at the time were receiving large amounts of cash from Jamiel Chagra's drug-trafficking activities, declared $1,521,830 in income from gambling in 1978 on their tax return" (Pet. App. A3).[4] The court rejected peti-

[4] The bare assertion on the return that petitioners received this sum as income from gambling has no weight, for petitioner Jamiel Chagra testified at trial that, on advice of counsel, he

tioners' argument that the Commissioner should have been required to prove a source of income for petitioners' cash expenditures. The court noted that a deficiency determination need only be supported by "rational underpinnings," a requirement satisfied here by the stipulation that petitioners spent more than they reported in income and by the absence of any evidence that they possessed a cash hoard (*id.* at A3-A4). The court concluded that (*id.* at A4):

> there is abundant evidence in the record that Jamiel Chagra was engaged in substantial drug trafficking. It is rational to conclude that he continued to receive income from drug trafficking in 1980 and 1981, despite the fact that he was a fugitive in the first two months of 1980 and was incarcerated thereafter. As the Tax Court noted, Petitioners spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income.

The court of appeals held that the question whether the Tax Court erred in refusing to award litigation costs to petitioners under 26 U.S.C. 7430 was not properly before it. The court noted that the motion for award of litigation costs was denied by order dated March 30, 1992. Petitioners' notice of appeal, however, specifically referred only to the Tax Court's decision on the merits dated July 8, 1992, and did not mention or incorporate the March 30, 1992, order on litigation costs. The court therefore declined to consider petitioners' contentions concerning the March

included income from drug sales as "gambling" income (Tr. 409-410, 428).

30, 1992, order denying litigation costs (Pet. App. A4-A5).

ARGUMENT

The fact-bound decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. For the 1980 and 1981 tax years, the Commissioner reconstructed taxpayers' income by the source and expenditure of funds method. See note 2, *supra*. The notice of deficiency stated that certain expenditures made by taxpayers during those years could not be traced to nontaxable sources of income or previously reported income and therefore constituted unreported income. Taxpayers stipulated to the expenditures asserted in the notice of deficiency. As the court of appeals stated, "Petitioners stipulated that their cash expenditures exceeded their reported income in 1980-1981. Since there is no evidence that they had a cash hoard, this stipulation supports the inference that they had some amount of unreported income" (Pet. App. A4).[5]

[5] *Llorente* v. *Commissioner*, 649 F.2d 152 (2d Cir. 1981), is not to the contrary. In *Llorente*, the Second Circuit recognized that the danger of a "naked assessment"—a notice of deficiency with no rational underpinning—is that the Commissioner could "place upon the taxpayer the unfair, and at time[s] impossible, burden of proving a negative, that he did not receive the illegal income assessed against him." *Id.* at 156. To protect the taxpayer from a naked assessment, "the evidence of record must at least link the taxpayer with some tax-generating acts." *Ibid.* When a taxpayer admits receipt of cash in excess of reported income, however, there is no danger of a naked assessment and the rational underpinning for a deficiency determination exists. See *Parks* v. *Commissioner*, 94 T.C. 654, 658 (1990);

Contrary to petitioners' contention (Pet. 7), in reaching this conclusion, the court of appeals did not make findings of fact or substitute its own findings for those of the Tax Court. The court of appeals noted that the Tax Court found that petitioners "spent over a million dollars in 1980 and 1981, despite the fact that they did not liquidate assets during those years and did not have any reported source of income" (Pet. App. A4). The inference to be drawn from the Tax Court's finding—that petitioners had unreported income during those years—was drawn by the Tax Court itself in its determination that petitioners were liable for a deficiency in income tax for those years. The court of appeals merely concluded that the findings of the Tax Court were not clearly erroneous.

2. Petitioners assert (Pet. 9) that the court of appeals erred in holding that petitioners had the burden of proving they were entitled to deductions. It is well settled, however, that deductions are a matter of legislative grace and that taxpayers have the burden of establishing their entitlement to deductions. *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934); Tax Ct. R. 142(a). Particularly with respect to the deduction for gambling losses permitted by the Code, Section 165(d) states that "[l]osses

Tokarski v. *Commissioner*, 87 T.C. 74, 76-77 (1986). In this case, the Commissioner's determination was plainly not arbitrary, for it is undisputed that the taxpayers' cash expenditures exceeded their reported income. As the court of appeals noted, "[s]ince there is a rational basis for the inference that [Petitioners had an unreported source of income,] Petitioners have the burden of proving that the amount the Respondent claims was income came from a non-taxable source" (Pet. App. A4).

from wagering transactions shall be allowed only to the extent of the gains from such transactions." 26 U.S.C. 165(d). In order for petitioners to obtain a deduction for wagering losses in the present case, it was thus their burden to prove the amount of income they had received from gambling. Petitioners failed, however, to offer any particularized evidence of the amount of income they received from gambling in that year. See note 4, *supra*.

Petitioners nonetheless contend (Pet. 8-10) that they had no burden of proving their entitlement to this deduction because the Commissioner asserted that the 1978 return was fraudulent. It is true that the Commissioner bears the burden of proving by clear and convincing evidence for each year in issue for which fraud is claimed that some portion of the underpayment was due to fraud. *Traficant* v. *Commissioner*, 884 F.2d 258, 264 (6th Cir. 1989); *Akland* v. *Commissioner*, 767 F.2d 618, 621 (9th Cir. 1985). Petitioners, however, confuse the government's burden of establishing fraud with their own burden under Section 165(d) of the Code to demonstrate that they had sufficient gambling income to *permit* a deduction for the $915,000 gambling debt paid in 1978. Once the Commissioner has established a prima facie case that the taxpayer has asserted a baseless deduction (see note 4, *supra*), the burden of going forward with evidence to the contrary shifts to the taxpayers. See *Papineau* v. *Commissioner*, 28 T.C. 54, 57 (1957).

3. The court of appeals correctly concluded that petitioners had failed properly to appeal the Tax Court's denial of their request for litigation costs (Pet. App. A4-A5). As the court noted, the notice of appeal seeks only "an appeal from the Tax Court's

decision of July 8, 1992," concerning the merits of the tax dispute (*id.* at A4). The notice of appeal makes no reference to the March 30, 1992, order denying their motion for litigation costs. See C.A. App. 127. And, the July 8, 1992, order does not mention or incorporate the March 30, 1992, order.

Rule 3(c) of the Federal Rules of Appellate Procedure requires the notice of appeal to "designate the judgment, order or part thereof appealed from" (Fed. R. App. P. 3(c)). If a party does not satisfy the requirements of Rule 3, then the appellate court does not acquire jurisdiction over the undesignated issues. *Torres* v. *Oakland Scavenger Co.*, 487 U.S. 312, 317 (1988) ("although a court may construe the Rules liberally in determining whether they have been complied with, it may not waive the jurisdictional requirements of Rules 3 and 4"). The courts have therefore held that, when an appeal is taken from a specified judgment or order, the appellate court acquires no jurisdiction over other judgments or orders not specified, or fairly encompassed, within the notice of appeal. See, *e.g.*, *Mariani-Giron* v. *Acevedo-Ruiz*, 945 F.2d 1, 3 (1st Cir. 1991); *Wilson* v. *Firestone Tire & Rubber Co.*, 932 F.2d 510, 516 (6th Cir. 1991); *Lockary* v. *Kayfetz*, 917 F.2d 1150, 1157 (9th Cir. 1990); *United States* v. *Rivera Construction Co.*, 863 F.2d 293, 298-299 (3d Cir. 1988); *Cole* v. *Tuttle*, 540 F.2d 206, 207 (5th Cir. 1976); *Symons* v. *Mueller Co.*, 526 F.2d 13, 19 (10th Cir. 1975). Appellate jurisdiction may exist over orders not specified in the notice of appeal if there is a functional connection between the specified and the unspecified order and the intention to appeal the unspecified order is apparent. That principle, however, "cannot be stretched to create appellate

jurisdiction over entirely collateral orders." *Williams* v. *Guzzardi*, 875 F.2d 46, 49 n.4 (3d Cir. 1989).[6] When an order not specified or referred to in a notice of appeal was not a "step in the procedural progression" of the order or judgment for which a timely notice of appeal has been filed, the issue is not fairly raised and the court of appeals does not acquire jurisdiction over it. *United States* v. *Rivera Construction Co.*, 863 F.2d at 298, quoting *Elfman Motors, Inc.* v. *Chrysler Corp.*, 567 F.2d 1252, 1254 (3d Cir. 1977) (per curiam). See also *Terkildsen* v. *Waters*, 481 F.2d 201, 206 (2d Cir. 1973); 9 *Moore's Federal Practice* ¶ 203.17[2], at 3-78 (2d ed. 1993).

Petitioners err in contending (Pet. 4) that the decision in this case conflicts with the decision of the Third Circuit in *Randazzo* v. *United States*, 751 F.2d 145 (3d Cir. 1984) (per curiam). The question in *Randazzo* was whether the taxpayer could appeal from an order denying litigation costs in a jeopardy assessment proceeding under Section 7429 of the Internal Revenue Code. While an order denying litigation costs is ordinarily "subject to appeal in the same manner as the decision" (26 U.S.C. 7430(f)(1)),[7]

[6] An order denying litigation costs is collateral to an order disposing of the merits of the case. *Budinich* v. *Becton Dickinson & Co.*, 486 U.S. 196, 200-201 (1988).

[7] As petitioners note, Section 7430(e) of the Code, as applicable in this case, provided that an order granting or denying an award of litigation costs in a Tax Court proceeding "shall be incorporated as a part of the decision or judgment in the case and shall be subject to appeal in the same manner as the decision or judgment." 26 U.S.C. 7430(e) (1982). This statute was amended in 1988, as to actions commenced after November 10, 1988, to provide that an order with respect to litigation costs "may be incorporated as a part of the decision or

Section 7429(f) provides that "[a]ny determination made by a court [in connection with the making of the jeopardy assessment] under this section shall be final and conclusive and shall not be reviewed by any other court." 26 U.S.C. 7429(f). In *Randazzo*, the Third Circuit held that, since the determination on the merits of a jeopardy assessment is not appealable under Section 7429(f), the order with respect to an award for reasonable litigation costs in a jeopardy assessment proceeding is also not appealable. 751 F.2d at 146.

The ruling in *Randazzo* has no application to cases, such as the present one, that do not involve non-appealable jeopardy assessment proceedings. The decision on the merits in the present case was clearly appealable. While petitioners *could* have appealed from both the denial of litigation costs and the decision on the merits in this case, they did not do so. See C.A. App. 127. The decision of the court of appeals in this case thus does not conflict with the analysis or the holding of *Randazzo*.

judgment * * * and shall be subject to appeal in the same manner as the decision or judgment." Omnibus Taxpayer Bill of Rights, Pub. L. No. 100-647, Tit. VI, Subtit. J, § 6239(a) and (d), 102 Stat. 3746 (codified at 26 U.S.C. 7430(f)(1)).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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OCTOBER 1993